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Fee simple vs leased fee in valuation - by Steve Hurlbut

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Steve Hurlbut
Liberty Bank

Recently, I had a question from a regulator as to why we appraised the leased fee interest in a multi-family property when the property isn't encumbered by any long term leases. My first thought was to write off the inquiry as to another misinformed regulator. But as I thought further about it I guess the question isn't so misinformed and the answer isn't so simple.

According to the Dictionary of Real Estate Appraisal, the definition of fee simple is: "Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the government powers of taxation, eminent domain, police power, and escheat."

The leased fee interest, which is typically used in the industry, is equivalent to the fee simple interest of a property that is leased to others. This view is based on the premise that a fee simple leased property contains two sets of property rights components, one being the real property interest (the fee simple interest) and the other a personal property interest (the lease contract).

When a leased property has a lease in place that is equal to the overall market rates of similar leased properties, the value of the leasehold interest in the property is zero. The net contributory value of the lease contract to the fee owner of the property is also zero, and this directly results in the market value of the leased fee interest to equal the market value of the fee simple interest. The full bundle of property rights held by an estate in real property, regardless whether the property is leased or owner occupied, can be identical because the full bundle is transacted from grantor to grantee through the execution of the real estate deed and the assignment of the personal property lease. It is only when current contract rents of the property being appraised are either below or above market rates that the traditional leased fee interest is being valued.

A lease contract does not remove any rights from the bundle of rights of the fee simple estate, but rather it is an addition to the fee simple estate. The bundle of rights is consistent with generally accepted appraisal practice where leased properties, whose contractual lease terms are at market levels, are said to have a value that is at "market," or is numerically equivalent to the fee simple value of the property. This means that the same set of real property rights can exist in all conveyed properties regardless if they are leased or owner occupied, and if the purpose of the appraisal

assignment is to value only the real estate the appraiser must simply remove the incremental value of the personal property component (the lease).

The Appraisal Institute recently held a property rights symposium to discuss differences of opinion relating to the valuation of fee simple estates. Long-standing valuation theory has held that the interests or rights in real estate are valued rather than the physical land and buildings themselves. Valuation standards require that the interests or rights be identified and reported in the valuation report. Appraisers have traditionally accomplished this task using terms such as fee simple, leased fee, or leasehold. When a property is leased and the value of a lease interest is sought, the valuation process will reflect the lease and account for any loss or benefit due to the rent being above or below market or loss due to the time and cost to lease vacant space. But when the assignment is to value the fee simple estate in property that is typically leased and sold as leased, the question arises as to whether it should be valued as though occupied or as though vacant.

This question is critical in eminent domain and property taxation where law or regulation generally requires the valuation of the fee simple estate, even if a lease exists. It is also an important question in mortgage lending when lease income is needed to repay the loan but there is risk of unexpected vacancy. In recent years, there have been numerous property tax appeal cases where the appropriate methodology for valuing the fee simple estate has been at issue; several states have adopted or proposed legislation that dictates methodology for assessment purposes.

If the definition is revised appraisers would need to determine, and the appraisals clearly state, the estate (fee simple, leasehold, or life estate) as well as the actual or assumed interests associated with the real estate that are reflected in the valuation. Depending on the question to be answered by the valuation (i.e., the problem to be solved) for a property that is leased, or would likely be leased, the valuation could be subject to the existing lease, subject to leases at market rates and terms, or as though vacant and available to be leased at market rates and terms. So the question wasn't as easy to answer I thought. Whatever direction the appraisal world chooses to go one thing is clear, the appraiser and client should be clear which interests should be valued. Stating property rights appraised as "Fee Simple interest of a property that is encumbered by a lease" may not be sufficient.

Steve Hurlbut is chief appraiser and vice president at Liberty Bank, Hartford, Conn.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540